

DOCKET SECTION

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POSTAL RATE COMMISSION  
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Postal Rate and Fee Changes, 1997 )

Docket No. R97-1

OFFICE OF THE CONSUMER ADVOCATE

TRIAL BRIEF

SHELLEY S. DREIFUSS  
Attorney

KENNETH E. RICHARDSON  
Attorney

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I. INTRODUCTION

Pursuant to P.O. Ruling R97-1/55, setting forth the revised procedural schedule in this case, the Office of the Consumer Advocate ("OCA") hereby submits its Trial Brief, due February 10, 1998. The Presiding Officer at the prehearing conference on July 30, 1997, directed parties to submit trial briefs prior to the appearance by their witnesses for cross-examination. Such briefs were to consist of an explanation of the theoretical and public policy considerations to which each party believed the Commission should give weight.<sup>1</sup> Noting that intervenor cases often focus on selected issues, the Presiding Officer stated that the "trial brief should explain how the proffered evidence should be used in reaching a recommended decision."<sup>2</sup> The trial briefs should thus include "applicable theories and policies . . . ."<sup>3</sup> Initial and reply briefs, on the other hand, should identify "record evidence which confirms your position and is contrary to opposing views."<sup>4</sup> In short, it appears that a major purpose of the trial brief is to give the Commission a road map to a participant's case so that the Commission can more easily evaluate the participant's case as it unfolds.

OCA believes the letter and spirit of the Presiding Officer's call for trial briefs is best met in the following manner. In Part II, OCA identifies policy objectives incorporated in the Postal Reorganization Act ("PRA"), which the Commission (and the

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<sup>1</sup> Docket No. R97-1, Tr. 1/27, 29.

<sup>2</sup> Id. at 29.

<sup>3</sup> Id.

<sup>4</sup> Id. at 30.

courts) have focused on in recent years. In Part III, OCA summarizes each of its witnesses' direct testimonies and explains how such testimony advances the policy objectives identified. Where appropriate, OCA will discuss why corresponding Postal Service proposals do not meet such objectives. In Part IV, OCA gives its preliminary views on four highly important data issues – (1) use of actual data on Postal Service costs and revenues, (2) distribution of mixed mail costs with greater precision, (3) lack of data for a reliable estimation of the volume variability of segment 3 costs, and (4) lack of data on the unique costs of handling additional ounces of First-Class Mail. In Part V, OCA briefly describes other issues it likely will address on brief.

## II. POLICY OBJECTIVES

It is axiomatic that policy objectives in Commission ratemaking and classification proceedings must be guided by the law. Under Title 39, Section 3622(b), the Commission is to make a recommended decision on a request for changes in rates or fees in each class of mail or type of service in accordance with the following factors:

- (1) the establishment and maintenance of a fair and equitable schedule;
- (2) the value of the mail service actually provided each class or type of mail service to both the sender and the recipient, including but not limited to the collection, mode of transportation, and priority of delivery;
- (3) the requirement that each class of mail or type of mail service bear the direct and indirect postal costs attributable to that class or type plus that portion of all other costs of the Postal Service reasonably assignable to such class or type;
- (4) the effect of rate increases upon the general public, business mail users, and enterprises in the private sector of the economy engaged in the delivery of mail matter other than letters;

- (5) the available alternative means of sending and receiving letters and other mail matter at reasonable costs;
- (6) the degree of preparation of mail for delivery into the postal system performed by the mailer and its effect upon reducing costs to the Postal Service;
- (7) simplicity of structure for the entire schedule and simple, identifiable relationships between the rates or fees charged the various classes of mail for postal services;
- (8) the educational, cultural, scientific, and informational value to the recipient of mail matter; and
- (9) such other factors as the Commission deems appropriate.

In addition, the Commission is directed by statute to "make a recommended decision on establishing or changing the [mail classification] schedule in accordance with the policies of [Title 39]" and its six enumerated criteria. 39 U.S.C. § 3623(c). The six criteria are:

- (1) establishment of a fair and equitable classification system for all mail;
- (2) the relative value to the people of the mail matter entered into the postal system and the desirability and justification for new or special classifications and services of mail;
- (3) the importance of providing classifications with extremely high degrees of reliability and speed of delivery;
- (4) the importance of providing classifications which do not require an extremely high degree of reliability and speed of delivery;
- (5) the desirability of special classifications from the point of view of both the mail user and that of the Postal Service; and
- (6) such other factors as the Commission may deem appropriate.

Out of these criteria, an overriding concern of the Office of the Consumer Advocate traditionally has been fairness and equity, or put another way, elimination of undue discriminations or preferences. This is grounded in the law. Title 39 calls for "the establishment and maintenance of a fair and equitable classification system *for all mail*." 39 U.S.C. 3623(c)(1) (emphasis added). Similarly, with respect to rates, it directs "the establishment and maintenance of a fair and equitable schedule." 39 U.S.C. § 3622(b)(1). "In providing services and in establishing classifications, rates, and fees . . . the Postal Service shall not, except as specifically authorized in this [Act], make any undue or unreasonable discrimination among users of the mail, nor shall it grant any undue or unreasonable preferences to any such user." 39 U.S.C. § 403(c). As noted by the D.C. Circuit Court of Appeals:<sup>5</sup>

"During the course of a ratemaking proceeding, the Commission has the authority, and indeed the duty, to assess the fairness and equity both of the proposals before it and of its own recommended decision to the Governors. 39 U.S.C. §§3622(b)(1), 3623(c)(1); see also *National Ass'n of Greeting Card Pubs. V. USPS*, 607 F.2d 392, 403 (D.C. Cir. 1979) ('the prevention of discrimination among the mail classes was major purpose of Congress in passing PRA) . . . .'"

OCA also is concerned that its proposals promote operational efficiency, for, ultimately, the public in general benefits when Postal Service costs decrease. Thus, OCA fully supports the efficiency objectives set forth by the Commission in a recent decision:<sup>6</sup>

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<sup>5</sup> *Mail Order Ass'n of America v. U.S. Postal Service*, 2 F.3d 408, 422-23 (D.C. Cir. 1993).

<sup>6</sup> PRC Op. MC95-1 at para. 24.

Automated mail processing has been advanced for more than a decade by the Postal Service as a promising source of operating efficiencies. The Commission has responded with recommended mail classifications and discounted rates that recognize the potential savings made possible by worksharing activities of users of the postal system who enter automation-compatible mail. The Commission remains committed to adapting mail classifications and postal rates to the demonstrated cost savings resulting from automated processing. The recommended classification structure, and associated rates and cost-based discounts, will encourage mailers to provide mail that is compatible with automated processing and the bulk bypass of processing that is deemed important by the Service.

Along with efficiency, OCA believes that Postal Service innovation that is consistent with statutory objectives also should be encouraged. As noted in a recent court decision: "While Congress hoped to achieve efficiency in postal operations by enacting the PRA, it also sought innovation. As the House Report noted, the Act 'envision[s] a national postal service that is forever searching for new markets and new ways by which the communication needs of the American people can be served.'" UPS Worldwide Forwarding v. U.S. Postal Serv., 66 F.3d 621, 638 (3d Cir. 1995).

OCA also has analyzed recent Commission decisions and found that the Commission is highly concerned about the validity of data, such as Postal Service costing methodologies and data collection.<sup>7</sup> Thus, in Docket No. R94-1, the Commission was concerned with omitted data,<sup>8</sup> reliability of existing costing systems,<sup>9</sup>

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<sup>7</sup> Accord, *Mail Order Ass'n*, *supra*, 2 F.3 at 430, quoting *Nat'l Ass'n of Greeting Card Pubs.* [citation omitted]: "The legislative history supports the Rate Commission's view that when causal analysis is limited by insufficient data, the statute envisions that the Rate Commission will press for better data, rather than construct an 'attribution' based on unsupported inferences of causation."

<sup>8</sup> PRC Op. R94-1 at I-9.

<sup>9</sup> *Id.* at I-11.

adequate review of studies,<sup>10</sup> and appropriate documentation.<sup>11</sup> Part IV. of this brief specifically responds to these general data concerns. Also in R94-1 considerable attention was paid to the appropriateness of various pricing strategies such as Ramsey pricing, an issue that OCA witness Sherman addresses.<sup>12</sup>

In Docket No. MC96-3, the Commission expressed concern over the quality of the Postal Service's major statistical systems,<sup>13</sup> disregard of established cost attribution principles,<sup>14</sup> and appropriate "roll forward" techniques.<sup>15</sup> OCA witness Smith offers testimony on the Postal Service's proposed changes in established costing methodologies, and Witness Thompson presents testimony on "roll forward" techniques. Also in that case, the Commission specifically addressed the costing methodology used to set post office box fees. Noting that OCA had proposed grouping by CAG rather than delivery groups, the Commission stated: "While it is not appropriate to act on the OCA's suggestion at this time, the Commission encourages the Postal Service to explore alternative post office box groupings in the future."<sup>16</sup> OCA Witness Callow offers testimony on this critical issue.

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<sup>10</sup> Id. at I-11-12.

<sup>11</sup> Id. at I-12.

<sup>12</sup> Id. at Appendix F.

<sup>13</sup> PRC Op. MC96-3 at 37-38.

<sup>14</sup> Id. at 31-36.

<sup>15</sup> Id. at 40. After attributable costs have been identified and distributed to subclasses and services in the base year, they are "rolled forward" to a test year by taking into account such things as inflation trends, productivity, and volume growth.

<sup>16</sup> Id. at 63. See also id. 67-68 for similar sentiments.

OCA's direct testimony is consistent with its mandate, as summarized in Appendix A to 39 C.F.R. §3002. This includes identifying information or data that are needed in addition to that presented by the parties; identifying inaccuracies or fallacies in submitted data or information; sponsoring relevant and material evidence which presents needed data or information, which critiques record evidence, or which supports proposals not inconsistent with Commission and judicial precedents; and to argue for equity on behalf of the general public, principally those segments not represented in the proceeding.

In its direct testimony, OCA has sought to respond to the concerns and policy objectives outlined above. In Section III, the direct testimony that OCA offers is described briefly, and then discussed in terms of the above policy objectives.

### III. SUMMARY OF OCA'S DIRECT TESTIMONY AND ITS CONSISTENCY WITH ACCEPTED POLICY OBJECTIVES

OCA's direct case consists of the testimony of witnesses Pamela A. Thompson (OCA-T-100), John O'Bannon (OCA-T-200), Dr. Roger A. Sherman (OCA-T-300), Gail Willette (OCA-T-400), James F. Callow (OCA-T-500), Dr. J. Edward Smith (OCA-T-600), and Sheryda C. Collins (OCA-T-700).

#### A. The Commission Cost Model

In OCA-T-100, Pamela A. Thompson, a postal rate and classification specialist, updates the Commission's cost model to reflect Postal Service costing methodology changes, then uses it to replicate the Postal Service's Base Year (FY1996); FY1997;



and FY 1998 (the Test Year) data. Her testimony gives the commands for executing the updated model, and provides intervenors a personal-computer-based cost model that may be used to replicate Postal Service costs and run alternative cost allocations, if they so wish.

The Commission updated its cost model in Docket No. R84-1 and in later dockets. In R84-1, the Commission stated that "the best way to validate the assumptions and data inputs of such a complex [Postal Service] model [is] to independently replicate each series of calculations made by the model." PRC Op. R84-1, Appendix E at 3. The Commission has provided updated copies of its cost model and all associated files as library references to its recommended opinions and decisions (see, e.g. Docket No. MC96-3, PRC-LR-5). However, the Commission's cost model operating instructions and documentation require a degree of familiarity with the Postal Service's costing methodology. The cost model documentation in witness Thompson's testimony and library references OCA-LR-4, OCA-LR-6 and OCA-LR-7 provide instructions on executing the Commission's cost model program for those users with minimal knowledge of the Postal Service's costing methodology.

Thus, the purpose of witness Thompson's testimony is to explain the procedures she followed to update the Commission's version of the Postal Service cost model. Additionally, her testimony provides intervenors an updated Commission cost model which allows a fuller discussion and a more accurate assessment of the statutory criteria set forth at 39 U.S.C. §3622(b), thereby fulfilling OCA's mandate to "sponsor[ ] relevant and material evidence which presents needed data or information." 39 C.F.R. §3002.

## B. Parcel Post Volume Changes

In OCA-T-200, John O'Bannon, an economist and doctoral candidate, examines Postal Service witness Mayes' testimony regarding Parcel Post, particularly those volumes in particular rate cells in the test year that would prevail after the requested rate change. He shows that for the DBMC category of Parcel Post, witness Mayes' estimated volume changes in certain rate cells imply positive implicit own-price elasticities. This results in the economic anomaly that increasing the rate for a particular cell of service spurs an increase in volume for that cell of service. This is true for some DBMC rate cells and results, in part, from the fact that the Postal Service believes the overall volume will increase for DBMC despite the fact that all but two cells experience rate increases. This computational result challenges universally accepted economic theory. Under typical assumptions, positive implicit own-price elasticities are an impossibility. Mr. O'Bannon demonstrates that the current method of allocating volume estimates to different rate cells within a category of mail is causing this problem.

Consistent with 39 C.F.R. §3002, Mr. O'Bannon's testimony identifies information in addition to that presented by the Postal Service, thereby identifying a general fallacy in witness Mayes' testimony. This testimony is also consistent with the Commission's general concern in recent dockets over proper costing methodologies, *supra*. In turn, identifying these problems will facilitate discussion of the relevant statutory criteria.

## C. Ramsey Pricing

In OCA-T-300, Dr. Roger Sherman, an economist, examines Ramsey prices. He first describes Ramsey prices and why they are superior to other pricing rules. He

then discusses the cost, demand, and demand elasticity data needed to estimate Ramsey prices. Dr. Sherman's method differs from the analytical approach used by Postal Service witness Bernstein by using long-run (instead of short-run) elasticities to forecast volume responses, which is advisable because the prices that are adopted should be in place beyond the period of the test year.

Dr. Sherman presents a summary of Ramsey prices and their effects, and compares this with Postal Service proposals at the level of five major mail classes. He finds that the overall welfare loss is greater under the Postal Service's proposed rates by more than \$1 billion. He then explores Ramsey prices under different constraints (such as RFRA), and presents such constrained prices and their effects for the main subclasses of mail, comparing them with Postal Service proposals. He shows that total welfare loss increases every time more constraints force prices farther from their pure Ramsey levels. He shows that the prices proposed by the Postal Service impose a welfare loss of \$3.159 billion, or about \$1 billion more than the most constrained Ramsey prices.

As noted previously, the Commission in Docket No. R94-1 expressed a strong interest in appropriate pricing strategies, specifically identifying Ramsey pricing. This portion of Dr. Sherman's testimony seeks to elucidate and improve upon the Ramsey pricing testimony presented by the Postal Service. It is hoped that his presentation will, in turn, enable the Commission and intervenors more fully to assess Ramsey pricing in light of the statutory pricing criteria set forth at 39 U.S.C. §3622(b).

D. Worksharing Discounts.

Also In OCA-T-300, Dr. Sherman examines worksharing discounts. After defining worksharing discounts, Dr. Sherman compares such discounts to “access” charges that allow one supplier of a service to use the resources of another supplier (e.g., one railroad uses another’s tracks). The “efficient components pricing” (ECP) principle of access pricing calls for the resource owner to be compensated for its own cost when granting access to others, thus motivating the resource owner to allow access and inviting low cost suppliers to participate in supplying the service. However, ECP assumes that volume shifts will be made abruptly. But when cross elasticities are not infinitely elastic at the crucial access price, then the cross elasticities should be taken into account in setting optimal prices.

A ready-made means of doing so exists in Ramsey prices. The Postal Service had examined this possibility by treating worksharing as another service, applying Ramsey principles in choosing prices to maximize welfare. Several problems complicate the estimation of Ramsey prices using information presently available. The wide range of mail pieces in the two mail streams complicates cost estimation for single-piece and worksharing letters. Another problem arises in the use of demand elasticity and cross elasticity information for the calculation of Ramsey prices.

Dr. Sherman concludes that other formulations may be important to examine. One could focus on the single-piece letter price as determinant of the total volume of letter mail. The discount from that price for worksharing would invite some fraction of that letter mail volume to become worksharing letters. The relevant discount elasticity would then be a supply elasticity, a willingness of mailers to provide worksharing effort

in response to changes in the discount. With this formulation, there would be no need for a single-piece letters discount elasticity. Nor would there be any role for an own-price elasticity of demand for worksharing letters. The volume of letters would depend on the price of letters and other factors, including the prices of other services that had nonzero cross elasticities with letters, but not on the level of the discount. By focusing on the demand for letter mail, together with the supply of worksharing, the problem can be formulated more simply and solved more effectively.

Dr. Sherman's exploration of potentially superior analyses of worksharing discounts is an attempt to bring such analysis more in line with the statutory pricing requirements, especially 39 U.S.C. §3622(b)(3) ("the requirement that each class of mail or type of mail service bear the direct and indirect postal costs attributable . . .") and 39 U.S.C. §3622(b)(3) ("the degree of preparation of mail for delivery into the postal system performed by the mailer . . ."). His analysis also supports the Commission's as well as the Postal Service's efficiency objectives. Finally, his analysis supports the Commission's efforts to improve costing analysis in its proceedings.

#### E. Cost Basis for Pricing.

Dr. Sherman further examines the Postal Service's estimation of volume variable and incremental cost. These cost concepts permit a better representation of marginal cost for pricing purposes, and should better equip the Service to avoid cross subsidy across mail services, but redesigning Postal Service accounting procedures may produce more reliable estimates. Little attention is now given to imputation of fixed

costs when they are caused by more than one service; shared costs deserve careful analysis and explanation to help determine the level at which cross-subsidy tests should be carried out. In some cases, incremental costs should be estimated for combinations of classes, and then tests for cross subsidy should be conducted for that combination of classes. The present effort focuses on incremental cost estimates for one class at a time. It may be that when fixed costs that are shared by services are imputed to those services, a larger portion of total costs would be seen as incremental, and more incremental cost tests could be conducted.

Dr. Sherman's analysis is consistent with recent Commission attempts to improve Postal Service data, e.g., statistical systems. In turn, this would better equip the Commission to fulfill its obligations under 39 U.S.C. §3622(b)(3) ("the requirement that each class of mail or type of mail service bear the direct and indirect postal costs attributable . . .").

#### F. Courtesy Envelope Mail

In OCA-T-400, Gail Willette, an economist and Director of the Office of the Consumer Advocate, presents testimony on the feasibility of Courtesy Envelope Mail ("CEM"). CEM mail would receive the same discount proposed by the Postal Service for Qualified Business Reply Mail ("QBRM") and Prepaid Reply Mail ("PRM") because the cost avoidance of CEM and PRM/QBRM letters is the same. However, CEM would not have the additional fees associated with PRM and QBRM.

Many businesses now provide courtesy reply mail, or CRM, envelopes to their customers, that enable them to introduce "clean mail" into the mailstream. CRM could be transformed into CEM easily and inexpensively, enabling consumers to take advantage of a "clean mail" rate lower than the First-Class rate. The CEM proposal enhances the Postal Service's PRM and QBRM proposals by giving providers a third, lower cost choice, one in which they can gain good will with customers by giving their customers the opportunity to use discounted CEM stamps.

CEM not only advances the Postal Service's stated objectives in this case but will do so in a way vastly superior to PRM. CEM addresses the threat of electronic diversion by providing consumers a convenient, but less expensive way to mail back bill payments. CEM also encourages the use of automation-compatible mail. It is operationally feasible because CRM providers who now enjoy a prebarcode discount will have to do almost nothing to comply with CEM regulations.

CEM also is consistent with statutory goals; we summarize the most relevant herein.<sup>17</sup> CEM will promote a fair and equitable classification system because it more closely aligns rates with costs for household mailers. In a Postal Service publication entitled "Max It! For the new value in business mail", Postmaster General Runyon states: "If it costs less for the Postal Service to process and deliver, it should cost less for you to mail."<sup>18</sup> OCA believes that these sentiments are equally relevant to mail sent by households. CEM envelopes avoid precisely the same costs as described by Postal Service witness Miller for PRM. In addition, CEM is fairer to those mailers who wish to

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<sup>17</sup> A fuller explication is found in witness Willette's direct testimony pp. 19 *et seq.*

offer their customers the advantage of reduced rates. Some business mailers' volumes preclude economical use of PRM while for others the cost of paying 30 cents in postage may be prohibitive.

As to "the relative value to the people of the kinds of mail matter entered into the postal system and the desirability and justification for special classifications and service of mail," consumers highly value the mail system as a means for returning bill payments. The desirability and justification for the CEM classification is that it more closely aligns rates with costs for household mailers and advances the Postal Service goals ascribed to PRM.

Concerning "the importance of providing classifications with extremely high degrees of reliability and speed of delivery," CEM mail is "clean" mail, the type most easily and economically processed by the Postal Service. Regarding "the desirability of special classifications from the point of view of both the user and of the Postal Service": (1) as to consumers, CEM is a realistic way to ensure that consumers will be paying a fair, equitable, cost-based First-Class rate for prebarcoded envelopes; (2) as to business mailers, CEM offers a practical and inexpensive way for them to gain good will by providing their customers the opportunity to use discounted postage.

In brief, then, CEM is consistent with the statutory pricing and classification criteria, especially those sections dealing with fairness and equity, and with the admonition of 39 U.S.C. § 403(c): "In providing services and in establishing classifications, rates, and fees . . . the Postal Service shall not, except as specifically

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<sup>18</sup> Exhibit A.



authorized in this [Act], make any undue or unreasonable discrimination among users of the mail, nor shall it grant any undue or unreasonable preferences to any such user.” 39 U.S.C. § 403(c). See also Nat’l Ass’n of Greeting Card Pubs. V. USPS, 607 F.2d 392, 403 (D.C. Cir. 1979)( ‘the prevention of discrimination among the mail classes was major purpose of Congress in passing PRA) . . . .”

Finally, the proposal supports innovation. OCA in general agrees with Postal Service witness Tolley that electronic diversion poses a threat to the Postal Service.<sup>19</sup> CEM is an innovative mail product that will help answer that threat by reducing the costs consumers incur when paying bills by mail.

#### G. Post Office Box Pricing

In OCA-T-500, James F. Callow, a postal rate and classification specialist, addresses the Postal Service’s post office box fee proposals. He proposes to restructure Fee Groups C and D into six new fee groups based upon the Cost Ascertainment Group (CAG) of post offices to create more rent-homogeneous groupings, as part of a transition to a further restructuring of these fee groups. His proposed fees reflect a new cost allocation methodology that distributes a substantial portion of volume-variable post office box costs by CAG. His proposed box fees in new fee groups CAG H-L are generally lower than under the Postal Service proposal, because their allocated costs are lower. Correspondingly, box fees are higher in other fee groups where allocated costs are higher. Witness Callow points out that average postal rental costs are higher in larger post offices, because larger post offices tend to

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<sup>19</sup> Docket No. R97-1, Direct Testimony of Postal Service witness Tolley, p. 51 *et seq.*

be located in higher-rent urban areas. Also, there are virtually no supervisors in offices CAG H or below.

Witness Callow's proposed post office box fees are fair and equitable, thus satisfying 39 U.S.C. § 3622(b). His fees for Fee Groups A and B are higher than those proposed by the Postal Service, reflecting the higher allocation of All Other costs to boxes in the larger CAG offices that comprise these fee groups. For the other fee groups, current post office box fees are misaligned with costs. Under current fees, boxholders who are similarly situated in terms of CAG pay vastly different rates. That is, boxholders with size 1 boxes in CAG A-D offices in Fee Group C pay much higher rates than size 1 boxholders in Fee Group D, i.e., \$40 and \$12, respectively. Nevertheless, unit box costs in the TYBR for size 1 boxes are much closer together, i.e., \$33.13 and \$30.68, respectively. The proposed fees begin to reduce this inequity and permit a more gradual transition to a further restructuring of the classification schedule.

As to "the value of the mail service actually provided," post office box service is an alternative delivery service that is valued by customers (e.g., privacy, security and the generally earlier availability of box mail vis-à-vis carrier delivery service). The value of such service is explicitly recognized in the elasticities the Commission adopted in Docket No. MC96-3, and used in developing witness Callow's after-rates volumes and revenues.

The third criterion -- recovery of attributable costs -- requires that revenues for each mail class or service be at least equal to the attributable costs for that class or

service. Witness Callow's proposed fees recover attributable costs and more, resulting in an implicit cost coverage of 107 percent. Including caller service and reserve call numbers results in combined net revenues of \$94.3 million, with a cost coverage of 116 percent (without the 1 percent contingency). This cost coverage is identical to the Postal Service's proposed cost coverage for post office boxes, caller service and reserve call numbers, i.e., 116 percent (without the 1 percent contingency).

Criterion number four concerns "the effect of rate increases" on the general public. Considerable attention was given to the effect of proposed fee increases on boxholders. Combining Fee Groups C and D to form three new fee groups by CAG was tabled at this time because of the significant percentage fee increases that could attend a uniform fee by box size for certain boxholders now in Fee Group D. In order to limit such percentage fee increases, three new fee groups were created from Fee Group D, with proposed fee increases limited to 100 percent for boxholders in CAG A-D offices in Fee Group D -- boxholders in the larger (CAG A-D) offices that comprise the new Fee Group D-I. In all, fee increases of this magnitude are limited to only 63,425 boxholders. Similarly, proposed fee increases for boxholders in CAG E-G offices in Fee Group D, which comprise new Fee Group D-II, are limited to 51 percent, nearly the same percentage fee increase proposed by the Postal Service. At the same time, fee increases for all boxholders in the smallest offices (i.e., CAG H-L) in Fee Group D, which comprise new Fee Group D-III, are limited to 25 percent. Boxholders in new Fee Groups C-III and D-III experience the lowest percentage fee increases, as compared to other boxholders from current Fee Groups C and D, respectively, because of the lower

allocated costs to boxes in the smaller offices that comprise new Fee Groups C-III and D-III.

The fifth criterion directs consideration to the role of available alternatives at reasonable cost. For those subject to the proposed box fee increases, the most feasible alternative is free carrier delivery service, if the proposed box fees are considered too high or private sector alternatives prohibitive.

Criterion number seven refers to the "simplicity of [the] structure for the entire schedule and simple, identifiable relationships between the rates or fees charged." For Fee Groups A, B and E, there is no change in the fee structure. The proposed fee group structure is more complex than the current fee group structure for some fee groups, but represents a balance between substantial fee increases for certain boxholders and a temporarily more complex fee structure for the Postal Service to administer.

The proposed new fee groups also accord with the Postal Reorganization Act's ("PRA") classification criteria, 39 U.S.C. §3623(c). The proposed new fee groups are fair and equitable in that they maintain the basic distinction in the existing fee group structure, i.e., that between boxholders eligible for carrier delivery service and those not eligible for carrier delivery, with boxholders eligible for delivery paying box fees, and those not eligible paying no box fees. Establishing three new fee groups by CAG begins the process of eliminating the dichotomy between Fee Groups C and D, where boxholders pay differing fees depending upon their eligibility for city or "rural" delivery,

respectively, and explicitly recognizes the similarities between these groups in terms of box service, the availability of carrier delivery service, and costs.

Classification criterion five concerns "the desirability of special classifications from the point of view of both the user and the Postal Service." From the point of view of boxholders, the new fee groups better reflect the costs of providing box service in post offices of comparable size. From the point of view of the Postal Service, the fact that boxholders in Fee Groups C and D are eligible for delivery services provided by either city or rural carriers would, in the future, no longer lead to significantly different post office box fees.

Finally, witness Callow's testimony seeks to address the Commission's stated interests in this area as expressed in the Commission's opinion in Docket No. MC96-3.

#### H. Volume Variable Cost Methodology for Segment 3

In OCA-T-600, Dr. J. Edward Smith, Jr., an economist, presents testimony commenting on the appropriateness, usefulness, and applicability of Postal Service witness Bradley's proposed cost/volume methodology (USPS-T-14). Dr. Smith believes that witness Bradley's economic framework is incomplete in terms of its explanation and justification of his cost equations and his failure to base his analysis on a production function. Nor is there adequate consideration of capital, technological change, and time trends. Dr. Smith also states that witness Bradley focuses incorrectly on short-run costs, without considering the longer term during which the proposed rates will be in effect. In addition, witness Bradley's study improperly omits considerations of equipment characteristics such as capital investment, equipment age and layout.

Commenting on witness Bradley's use of a fixed effects model, Dr. Smith believes that a pooled effects approach is more consistent with the underlying form of the data and the time period over which the rates will be in effect. Dr. Smith is of the opinion that witness Bradley's analysis needs to incorporate additional variables to provide an improved understanding of cost drivers. Additional review of the data scrubbing process is needed, as is substantiation of the applicability of his conclusions based on MODS data as related to non-MODS facilities. Dr. Smith observes that a simple plotting of the scrubbed data is at variance with witness Bradley's conclusions. Dr. Smith states that witness Bradley's approach fails to meet generally accepted regulatory standards. Dr. Smith concludes that witness Bradley's study needs additional work and that implementation of the study in its current form would be inappropriate.

Consistent with 39 C.F.R. §3002, Dr. Smith's testimony identifies possible errors and theoretical fallacies in witness Bradley's testimony. Dr. Smith's testimony is consistent with the Commission's general concern in recent dockets over proper costing methodologies, e.g., omitted data, reliability of costing systems, review of studies, and disregard of established attribution principles. In turn, identifying costing methodology problems will facilitate discussion of the relevant statutory criteria.

#### I. Standard B Library Rate mail

In OCA-T-700, Sheryda C. Collins, a postal rate and classification analyst, presents an alternative to the Postal Service's proposed rates for Standard B Library Rate mail. Because Library Rate is a low volume subclass, the small number of IOCS

tallies related to Library Rate and from which the Library Rate costs are derived is an extremely thin sample and, therefore, may not provide truly representative cost estimates of the subclass. Use of the reported attributable costs of Library Rate mail produces unacceptably high rates -- the subclass with a presumptive rate preference ends up with rates higher than the regular subclass. She proposes that the Commission use the costs of the Standard B Special Rate subclass as a proxy for the costs calculated for Library Rate.

Witness Collin's testimony is consistent with the Commission's interest stated in numerous cases that costing analyses be empirically and theoretically supportable. The Postal Service proposal results in a statistical distortion. Not substituting Special Rate costs for Library Rate creates a *de facto* merger of the two subclasses, improperly eliminating by administrative fiat a preferred rate category created by Congress.

#### IV. VALIDITY OF DATA

In this section, OCA outlines its position on four highly important data issues -- (1) use of actual data on Postal Service costs and revenues, (2) distribution of mixed mail costs with greater precision, (3) lack of data for a reliable estimation of the volume variability of segment 3 costs, and (4) lack of data on the unique costs of handling additional ounces of First-Class Mail. Although OCA is not sponsoring witnesses on these issues, it will address them in its initial brief.<sup>20</sup>

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<sup>20</sup> In addition, the actual data issue will be addressed in a response to NOI No. 5.

A. USE OF ACTUAL DATA

The actual earnings of the Postal Service for 1997 and the reported earnings for the first quarter of 1998 raise serious questions concerning the use of actual data. The Commission Notice of Inquiry No. 5, issued January 28, 1998, requested comments on whether the Commission should recognize actual 1997 Postal Service net income and, if so, why. The Commission also asked what methods would be appropriate for reflecting that information.

The OCA will file its response on February 13 recommending the Commission *take the necessary steps to assure that all the available actual cost data, including 1998 data, is incorporated into the record for the Commission's consideration.* The increasingly glowing earnings picture of the Postal Service requires the Commission not only to recognize 1997 actual data but to consider the available 1998 actual data.

A positive trend in the Postal Service earnings exists which regularly not only exceeds the estimates in the July 10, 1997, rate filing but seems to exceed each previous updated estimate. If these earnings are reasonably projected for the full test year, it can be readily argued there is a strong probability that the Postal Service will actually have a net profit for the 1998 test year. If the current trends continue, even if there is a loss, it would be so small that any significant rate level increases would yield unneeded profits for the Postal Service. The minimum practical increase of one cent in the First-Class rate would almost certainly provide excess profits, even if no other rates were increased.

The future test year approach worked well during periods of increasing inflation and sharply rising costs to prevent immediate shortfalls following newly increased rates



and to prevent constant rate filings. In today's economic environment of low, stable inflation and unexpected expense savings and volume growth in the Postal Service, the future test year methodology could result in unnecessary profits unless actual data is recognized in the deliberative process.

Recognition of actual data for the test year is not a revolutionary concept. The use of historical data for test year purposes in regulation is by far the more common method with updates to the actual data to provide for future known and measurable changes. See Garfield and Lovejoy, Public Utility Economics (Prentice-Hall, Inc., 1961), at 50.

The use of actual data will result in a large reduction in the revenue requirement. The Commission has the authority to reduce the estimated revenue requirement based upon record evidence and other appropriate evidence available to it. The Postal Service has the management prerogative in the first instance to determine its revenue requirement, but the Commission is bound by the duty to review the cost and revenue estimates submitted by the Postal Service to determine whether the expenses and volumes will be as projected. PRC Op. R71-1 at 1-268-271.

The OCA will speak to these issues at greater length in its response to the NOI.

**B. SUPERIORITY OF WITNESS DEGEN'S DISTRIBUTION OF  
UNCOUNTED MIXED-MAIL PROCESSING COSTS TO EARLIER  
DISTRIBUTIONS OF SUCH COSTS BY LIOCATT**

This subsection of the trial brief discusses the improvement in the distribution of mixed-mail component 3.1 costs, styled by Postal Service witness Degen as a

response to one of the three major criticisms in the allocation of clerk and mailhandler (CAG A-J) costs to subclasses. USPS-T-12 at 5. OCA commends the Postal Service for expending the resources and effort necessary to increase the precision of the distribution of costs for its largest cost segment.<sup>21</sup>

United Parcel Service (UPS) witness Sellick points out that the improvement in the distribution of component 3.1 costs is essentially twofold: 1) distribution of mixed-mail and overhead costs are linked with the operational characteristics of mail processing, and 2) information on the contents of items, such as sacks, bundles, and trays, is used more completely than in previous proceedings. UPS-T-2 at 4.

This echoes witness Degen's description of the advantages of the "revised method" he proposes:<sup>22</sup>

I believe the revisions to the costing methodology produce more accurate observations for several reasons. First, the MODS-based cost pool formation does not depend on a sampling system. Second, the volume-variable overhead costs are part of the variable cost pools and are distributed to subclass using pool-specific keys--a much finer and more accurate level of distribution than the old methodology . . . . Third, mixed-mail costs such as costs associated with activity code 5750 (mixed mail with no class or shape data) are incorporated in the cost pool dollars, and the distribution of these costs has been refined using the mail operation and mail identification information collected in IOCS questions 21 and 24.

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<sup>21</sup> While OCA finds witness Degen's distribution of mixed-mail costs praiseworthy, we do have grave reservations concerning witness Bradley's determination of volume variabilities for the cost pools identified by witness Degen. See the testimony of OCA witness J. Edward Smith, OCA-T-600.

<sup>22</sup> Tr. 12/6294-95 (interrogatory OCA/USPS-T12-17), (citation omitted).

Witness Degen uses information from the Management Operating Data System (MODS) to partition labor costs into "cost pools based on mail processing activities and machinery types."<sup>23</sup> USPS-T-12 at 5. The partitions are then used to maximum effect by "confining mixed mail distributions to direct tallies associated with the same cost pool." *Id.* (Footnote omitted). UPS witness Sellick makes a detailed comparison of the advantages of the Degen distribution method over the LIOCATT method used in earlier cases. Mixed-mail tallies distributed by LIOCATT are comparatively crude, and connect mixed-mail costs to subclasses only within broad CAG/Basic Function categories. By contrast, the Degen "revised" approach makes these associations far more narrowly, at the level of particular MODS operations and activities. UPS-T-2 at 7. Furthermore, uncounted items,<sup>24</sup> uncounted containers,<sup>25</sup> empty containers, and overhead are related with greater exactness to carefully defined cost pools. *Id.*

CAG levels, of course, result from classification according to the amount of revenue generated by facilities, an attribute that seems only distantly related to the determination of a subclass' responsibility for costs associated with a mixed group of

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<sup>23</sup> His partitioning of costs into MODS-based cost pools, as opposed to IOCS activity classifications, results in a shift of approximately \$792,015,000 from Window Service (component 3.2--decreases by \$106,585,000) and Administrative (component 3.3--decreases by \$685,427,000) into Mail Processing (component 3.1). Tr. 12/6376 (interrogatory OCA/USPS-T15-21); *id.* at 6377 (interrogatory OCA/USPS-T5-22); and *id.* at 6379 (interrogatory OCA/USPS-T5-23).

<sup>24</sup> "Items' include sacks, pouches, bundles, trays, and pallets." PRC Op. R94-1 at III-13, n.28; also, USPS-T-12 at 3, n.3.

<sup>25</sup> "Containers" are large, wheeled, pieces of equipment such as hampers, BMC Over-the-Road containers, General Purpose containers, All Purpose containers, nutting trucks, Postal Paks, utility carts, and wiretainers. PRC Op. R94-1 at para. 3035; also USPS-T-12 at 3, n.3.

mail. The division of mixed-mail into the Basic Functional categories—Incoming, Outgoing, Transit, and Other—is equally remote from the effort to find the causal connection between subclasses and mixed-mail activities.

Witness Sellick convincingly explains that:

[C]ost pools represent a much finer level of distribution than LIOCATT. The new pools relate to operational characteristics and machine type, which affect the costs incurred in processing mail . . . The new method treats mixed mail observed in OCR operations, for example, as likely to be similar to direct mail at OCR operations. The old method was much less refined; it assumed that mixed mail observed in OCR operations was similar to all direct mail at postal facilities of a similar size and Basic Function. The old method ignored the fact that mixed mail at OCR operations is more likely to resemble direct mail at OCR operations than direct mail at OCR and non-OCR operations.

Id. at 8. (Emphasis in original).

Another material improvement in mixed-mail distribution is witness Degen's augmentation of "counted mail" observations from IOCS data collection with estimated percentages of the proportion of mail, by shape and type, within uncounted containers or items. Witness Degen describes the refinement he makes in the instant proceeding in this way:

For a majority of containers, the data collector recorded the percentage of the container's volume (cube) occupied by shapes of loose mail and/or items. These are referred to as identified containers and the recorded percentages are used to partition the tally dollars by loose shape and item type. . . . The identified container distributions are formed within cost pools. . . . The revised approach is a considerable refinement of the existing mixed-mail methodology for several reasons. It exploits the association of item types with certain shapes and/or subclasses of mail, in effect using item types as mixed-mail categories. For containers with more than one shape of mail or item type, it weights the direct distributions based on the *observed container contents*. In contrast, the LIOCATT mixed-mail method assumes that containers with mixed shapes

of mail contain the shapes in the proportions of the appropriate direct tallies outside of containers.

USPS-T-12 at 9-10. (Emphasis added).

Notwithstanding criticisms by Time Warner witness Stralberg,<sup>26</sup> the Postal Service's post-1992 practice of counting pieces within items and containers has been usefully supplemented by "eyeballing" or estimating the percentage of containers occupied by specified types of mail. Tr. 12/6297-99 (Witness Degen's response to interrogatory OCA/USPS-T12-19). Witness Stralberg would have the Commission ignore the supplemental information now collected in response to question 21D of the IOCS data collection form. See LR H-49 at 92-93.<sup>27</sup> Although he claims that his position is consistent with that adopted by the Commission in Docket No. R94-1,<sup>28</sup> this is not the case. The wisdom of using whatever data is available (even if there is some question of bias) is certainly the overarching principle in the Commission's decision:

The Commission believes that the uncounted mixed-mail costs will be more accurately distributed with IOCS data which include the small portion of counted mixed-mail data. . . . [B]ecause the Postal Service counted the number of pieces in each class in the items which were counted, converting those "direct counts" of mixed mail observations into direct tallies is appropriate. Using the counted mixed-mail tallies as part of the direct tally base for distributing uncounted mixed-mail costs is the preferable approach.

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<sup>26</sup> TW-T-1, *inter alia*.

<sup>27</sup> Witness Degen recounts that, following a January 1992 revision to question 21D of the IOCS, data collectors "record[ed] percentages of volume occupied by each item type and shape of loose mail present in the container," when they were unable to make an actual count. Tr. 12/6312 (Response to interrogatory OCA/USPS-T12-28).

<sup>28</sup> TW-T-1 at 8 and 13.

While it is true that the Commission did not approve of the practice of using counted mixed-mail, in isolation, as the distribution key for remaining mixed-mail costs, witness Degen has not proposed to do so in this case. Rather, Degen uses “direct items,” (defined by him as counted mixed-mail items, items and containers containing identical mail, and items and containers subject to the top piece rule), as the distribution key for uncounted mixed-mail costs *within the same cost pool*. USPS-T-12 at 9. Furthermore, as discussed above, witness Degen also incorporates “identified container” percentage data in the distribution process, within the same cost pool. Witness Degen’s use of counted and identified data as the distribution key only where there is a strong connection to other distributed mixed-mail costs, i.e., within cost pools, is entirely consistent with the Commission’s position in Docket No. R94-1. He reasons that:<sup>29</sup>

Examination of identified container contents is useful in identifying appropriate distribution keys for mixed-mail containers because there are strong shape and/or subclass associations with the loose mail shapes and item types. For instance, the portion of costs associated with a container’s loose letters content would only be distributed to activity codes for letter-shape mail categories.

Ignoring information such as this, he states, may produce a biased distribution key.<sup>30</sup>

For the reasons outlined above, OCA urges the Commission to adopt witness Degen’s method of distributing uncounted mixed-mail costs.

### C. MAIL PROCESSING COST VARIABILITY

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<sup>29</sup> Tr. 12/6122.

<sup>30</sup> Id. at 6229.

Witness Shew, on behalf of Dow Jones & Company, endorses and commends witness Bradley's investigation of how mail processing costs vary with volume, but witness Shew in general provides inadequate substantiation for his comments. Also, a number of witness Shew's statements inadvertently highlight major problems with witness Bradley's study.

Witness Shew discusses the variability of mail processing costs as the volume of mail changes and economies of scale—as if these were identical or related.<sup>31</sup> They are not, as measured by witness Bradley. In measuring costs, witness Bradley has focused on short-run changes, but economies of scale are of a longer-run nature. Witness Shew has incorrectly intermingled the two concepts. Although witness Bradley's methodology measures short-run cost changes, the relevant measure of cost as volume changes is a longer-run measurement of the change in processing costs as the scale volume for the processing activity changes. Witness Bradley does not properly account for scale volume in his study. This is a key defect of the study.

Witness Shew also states:<sup>32</sup>

But even the relatively simple formulation used by Professor Bradley yields some interesting conclusions about labor productivity trends. In the majority of mail processing activities, he finds, labor productivity increased from 1988 to 1992, but has declined since then, holding constant other factors such as mail volume. The cause of the reversal in productivity is not revealed by his analysis, but it seems quite pervasive.

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<sup>31</sup> Direct Testimony of Shew, DJ-T-1 at 10, line 10.

<sup>32</sup> Id. at 16, lines 1-5.

Witness Shew's comment is, in fact, damaging to witness Bradley's case. In view of the ongoing efficiency efforts and investments in productivity by the Postal Service, one would expect the opposite--or at least a model capable of explaining the underlying productivity trends--especially in view of witness Bradley's discussion of technological change. This is another and major example of a deficiency in witness Bradley's study.

On the other hand, OCA endorses the following statement by witness Shew:<sup>33</sup>

Its usefulness as an analytic tool might be further expanded if, in future versions of the study, the labor cost of mail processing were measured in dollar terms as well as hours and if the investment in plant and equipment associated each activity at each site were included as explanatory variables.

The fact that the cost study does not have dollar costs in it or any discussion of plant and equipment appears to OCA to be another key deficiency of the study.

Witness Cohen, testifying for Magazine Publishers of America (MPA), endorses witness Bradley's study and, like Shew, provides no substantiation for her comments. She relates witness Bradley's and witness Moden's discussions of fixed functions as related to volume processed.<sup>34</sup> Again, such discussions are short-term oriented and do not track costs over the period during which rates will be in effect and operations expanded or contracted.

Witness Stralberg, testifying for Time Warner, Inc. urges the Commission to accept witness Bradley's study as being intuitively obvious.<sup>35</sup> In contrast, the OCA

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<sup>33</sup> Id. at 18, lines 7-10.

<sup>34</sup> Direct Testimony of Cohen, MPA-T-2 at 16-17.

<sup>35</sup> Direct Testimony of Stralberg, TW-T-1 at 3.



believes 100% variability intuitively obvious. However, this mail processing issue is not about intuition but about cost causation. Accordingly, witness Stralberg provides no substantiation for witness Bradley's study.

D. URGENCY OF IDENTIFYING THE UNIQUE COSTS OF ADDITIONAL OUNCES OF FIRST-CLASS MAIL

Although exhorted to study the unique costs of additional ounces of First-Class Mail by the Commission over the past decade and a half,<sup>36</sup> the Postal Service has failed to do so again in its current Request. OCA can only conclude that the Service does not wish to stem the flow of "easy money" by seriously investigating whether second and third ounces of letter-shaped First-Class Mail add *any* costs to those calculated for the processing and delivery of one-ounce letters.

In its most recent omnibus rate case opinion, the Commission expressed doubt that letters weighing up to three ounces would generate more than minimal additional costs and stated the belief that "possibly no extra cost" for such letters could be the case.<sup>37</sup> With the introduction of remote encoding, even hand-addressed letters enjoy the benefits of highly automated processing, a condition that the Commission believed would contribute to the minimal or no-cost handling of two- and three-ounce letters.<sup>38</sup>

The American Bankers Association and the Newspaper Association of America have sponsored the testimony of witness Clifton in this proceeding—ABA/NAA-T-1—

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<sup>36</sup> E.g., Docket No. R94-1, discussed *infra*; PRC Op. R87-1 at para. 5100; and PRC Op. R84-1 at paras. 5034-35.

<sup>37</sup> PRC Op. R94-1 at para. 5030.

<sup>38</sup> *Id.*

which calls for a dramatic reduction in the second ounce rate for workshared First-Class Mail. Based on a calculated attributable cost of only 2.5 cents for an additional ounce or two of First-Class Mail (*id.* at 13), witness Clifton proposes a second-ounce rate of 12 cents (*id.* at 12). Even this near-fifty-percent reduction in the current 23-cent additional-ounce rate yields an implied cost coverage of 480 percent. *Id.* at 13.

In calculating the attributable cost of 2.5 cents for an additional ounce, witness Clifton was forced to rely upon library references furnished by the Postal Service in Dockets R94-1 and R90-1. Clifton's Technical Appendix A at A-1. Mail processing has changed considerably over that period of time, particularly since the major reclassification in Docket No. MC95-1 and the widespread use of remote encoding. The Postal Service has been derelict in acting upon Commission directives that it study the additional-ounce costs reliably so that they could be used as the basis for a fair additional-ounce rate. If the Commission decides to recommend the 12-cent second-ounce rate proposed by witness Clifton, as a matter of equity, it should seriously consider reducing the additional-ounce rates paid by single-piece First-Class Mail as well.

#### V. OTHER ISSUES OCA LIKELY WILL ADDRESS ON BRIEF

OCA likely will address other issues on brief as well.<sup>39</sup> For example, OCA already has expressed its concerns in Docket No. MC97-5 about the lack of information consumers receive from the Postal Service about the nature of the postal insurance


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<sup>39</sup> This listing is not exhaustive. For example, issues may arise in the presentation of intervenors' direct cases that deserve comment.

they purchase.<sup>40</sup> This lack-of-notice issue transcends the Docket No. MC97-5 proceeding, and is especially important given the substantial increases in insurance fees proposed by the Postal Service in this docket.<sup>41</sup>

OCA also will brief the issue of undue discrimination as it applies to making services available to the public generally, and not just for the convenience of high volume mailers. This issue is relevant, e.g., because of the Postal Service proposal to increase the maximum size limit on packages it will accept only from high volume mailers.<sup>42</sup>

Respectfully submitted,

  
SHELLEY S. DREIFUSS  
Attorney

  
KENNETH E. RICHARDSON  
Attorney

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<sup>40</sup> OCA Initial and Reply Briefs, Docket No. MC97-5.

<sup>41</sup> See Direct Testimony of Postal Service witness Plunkett, USPS-T-40, at 3-9.

<sup>42</sup> See, e.g., revised response of Postal Service witness Mayes to OCA/USPS-T37-5.

## CERTIFICATE OF SERVICE

I hereby certify that I have this date served the foregoing document upon all participants of record in this proceeding in accordance with section 12 of the rules of practice.

  
SHELLEY S. DREIFUSS  
Attorney

Washington, D.C. 20268-0001  
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